UNITED STATES DISTRICT COURT

DISTRICT OF MAINE

ROBERT A. ROSE, ET AL.,	)	
	)	
PLAINTIFFS	)	
	)	
v.	)	**Civil No. 98-5-P-H**
	)	
DAVID SHAW, ET AL.,	)	
	)	
DEFENDANTS	)	

ORDER AFFIRMING IN PART AND REJECTING IN PART RECOMMENDED DECISION OF THE MAGISTRATE JUDGE

The United States Magistrate Judge filed with the court on December 30, 1998, with copies to counsel, his Recommended Decision on Defendants' Motion to Dismiss. The defendant IDEXX filed an objection to the Magistrate Judge's Recommended Decision on January 14, 1999, and the plaintiffs filed an objection on January 19, 1999. I have reviewed and considered the Magistrate Judge's Recommended Decision, together with the entire record; I have made a de novo determination of all matters adjudicated by the Magistrate Judge's Recommended Decision; and I concur with the recommendations of the United States Magistrate Judge except as noted below and with the following elaborations.

1. I begin with the observation that the Private Securities Litigation Reform Act of 1995 and First Circuit caselaw interpreting Fed. R. Civ. P. 9(b) are very hostile to these lawsuits and require the plaintiffs to jump many hurdles to survive a motion to dismiss. Those hurdles have been placed there intentionally, however, and it is the job of the trial courts to see that they are met.

2. The Magistrate Judge has properly disposed of any claim here based on insider trading. He has also properly assessed the allegations that fraud occurred through making materially incomplete and thereby misleading statements. I limit my comments here to the plaintiffs' argument that they have a cause of action under Section 10(b) for a mere failure to disclose information.

The First Circuit has made clear in Gross v. Summa Four, Inc., 93 F.3d 987, 992 (1st Cir. 1996), that Section 10(b) and Rule 10b-5 do not create any affirmative duty to disclose; instead, the source of any duty to disclose must be found outside Section 10(b) and Rule 10b-5. I agree with Judge Cohen's interpretation of Shaw v. Digital Equipment Corp., 82 F.3d 1194 (1st Cir. 1996), and conclude that in this case (dealing with Forms 10-Q or 10-K) such a duty cannot be located in Item 303 of Regulation S-K, 17 C.F.R. § 229.303.

The caselaw is in substantial disarray. Gross and Shaw both used footnotes to convert an earlier case's description of a party's argument into apparently underlying First Circuit principle: specifically, that where a statute or regulation requires disclosure there can be a cause of action under Rule 10b-5 and Section 10(b) for failure to disclose. See Gross, 93 F.3d at 992 n.4; Shaw, 82 F.3d at 1202 n.3 (both cases citing Roeder v. Alpha Indus. Inc., 814 F.2d 22, 27 (1st Cir. 1987)). But in the only case where the First Circuit has affirmatively recognized a 10b-(5) cause of action for violation of an SEC rule, namely the Shaw case, the court took pains to explain its conclusion as based upon the fact that a public offering was involved and limited its holding accordingly. (The court was troubled that people who bought the stock in the public offering had an express cause of action under Section 11 and Section 12(2) of the Securities Act for violations of Item 11(a) of Form S-3, but that without the 10b-5 remedy under the Exchange Act people who had read the same materials and had purchased in the secondary market would have no cause of action. Therefore, the court recognized

the cause of action in the public offering context. See 82 F.3d at 1221-22 & 1222 n.37.) The court stated explicitly:

> In so holding, we do not intend to create a private right of action under Section 10(b) for violations of any SEC rule. Our holding is limited to the proposition that, in the context of a public offering, plaintiffs who (through the market) rely upon the completeness of a registration statement or prospectus may sue under Section 10(b) and Rule 10b-5 for nondisclosures of material facts omitted from those documents in violation of the applicable SEC rules and regulations.

Id. at 1222 n.37. Thus, the First Circuit has neither explicitly nor implicitly recognized a private cause of action under Rule 10b-5 for a violation of Item 303 in the situation here, which is outside the context of a public offering.

Only two other Circuits have spoken. After declining to decide the issue in 1993, see In re Wells Fargo Sec. Litig., 12 F.3d 922, 930 n.6 (9th Cir. 1993), the Ninth Circuit held implicitly in 1998 that there is no 10b-5 cause of action for violation of Item 303, see Steckman v. Hart Brewing, Inc., 143 F.3d 1293, 1296 (9th Cir. 1998) (holding that violation of Item 303 is actionable under the Securities Act but suggesting that such violations are not actionable under the Exchange Act).[1] The Sixth Circuit Court of Appeals responded to a plaintiff's argument that a private cause of action exists under Rule 10b-5 for violation of Item 303 with an unenthusiastic "[p]erhaps so," but then went on to find the plaintiff's argument defective for other reasons. In re Sofamor Danek Group, Inc., 123 F.3d

[1] Some district courts read the 1993 decision in In re Verifone Securities Litigation, 11 F.3d 865 (9th Cir. 1993), as reaching that conclusion, see Kriendler v. Chemical Waste Mgmt., Inc., 877 F. Supp. 1140, 1157 (N.D. Ill. 1995), but Verifone actually held only that no 10b-5 cause of action existed for violation of a stock exchange rule. See 11 F.3d at 870.

394, 403 (6th Cir. 1997), cert. denied sub nom. Murphy v. Sofamor Danek Group, 118 S. Ct. 1675 (1998).[2]

In the district courts, two districts have found that there is a cause of action under Rule 10b-5 for a violation of Item 303. See Simon v. American Power Conversion Corp., 945 F. Supp. 416, 431 & n.20 (D.R.I. 1996); Wallace v. Systems & Computer Tech. Corp., 1997 Fed. Sec. L. Rep. ¶ 99,578, 1997 WL 602808 at *25 (E.D. Pa.). Four districts have found that there is no cause of action under Rule 10b-5 for a violation of Item 303. See In re Boston Tech., Inc. Sec. Litig., 8 F. Supp. 2d 43, 67 (D. Mass. 1998); In re Herbalife Sec. Litig., 1996 U.S. Dist. LEXIS 11484 at *13 n.5 (C.D. Cal.); Kriendler v. Chemical Waste Mgmt., Inc., 877 F. Supp. 1140, 1157 (N.D. Ill. 1995); In re Caere Corporate Sec. Litig., 837 F. Supp. 1054, 1061 n.4 (N.D. Cal. 1993).[3] One of these districts and two others have ruled that an Item 303 violation, though not a breach of duty actionable under Rule 10b-5, may be relevant evidence on various elements of the 10b-5 action. See In re F&M Distribs., Inc. Sec. Litig., 937 F. Supp. 647, 654 (E.D. Mich. 1996) (materiality); Freedman v. Louisiana-Pacific Corp., 922 F. Supp. 377, 390 (D. Or. 1996) (scienter); Wilensky v. Digital Equip. Corp., 903 F. Supp. 173, 181 (D. Mass. 1995) (scheme to defraud), aff'd in part and rev'd in part sub nom. Shaw v. Digital Equip. Corp., 82 F.3d 1194 (1st Cir. 1996).[4] The Southern District of New York has avoided this

[2] While the Sixth and Ninth Circuits have spoken to this issue, the Third Circuit has expressly declined to do so. See In re Burlington Coat Factory Sec. Litig., 114 F.3d 1410, 1419 n.7 (3d Cir. 1997).

[3] As Herbalife is an unreported decision, I have accorded it no weight. I cite it only to inform the parties who have cited it to me that I am aware of it.

[4] Wilensky involved three consolidated class actions, only two of which (the Shaw and Wilensky actions) were on appeal in Shaw. The trial court's observation that an Item 303 violation may be evidence of a scheme to defraud was made with reference to the third class action (the Lonergan action) which was not reviewed in Shaw.

issue by finding no actual violation of Item 303, but the court expressed doubt that a violation of Item 303 gives rise to a private right of action under 10b-5. See In re Canandaigua Sec. Litig., 944 F. Supp. 1202, 1209-10, 1209 n.4 (S.D.N.Y. 1996). The District of New Jersey has recently taken the same approach. See Oran v. Stafford, ___ F. Supp.2d ___, 1999 WL 64475 at *5 & n.6 (D.N.J.).

The cause of action for violation of Rule 10b-5 and Section 10(b) is, of course, a judicially-created cause of action. Like Magistrate Judge Cohen, I read the Shaw decision as expressing the First Circuit's reluctance to extend this implied cause of action by creating or recognizing a duty out of a failure to comply with some other SEC rule or regulation. This case does not present the incongruity Shaw faced. I therefore agree with Judge Cohen that the First Circuit does not recognize a 10b-5 cause of action for the mere failure to make a disclosure mandated by Item 303.

3. On the authority of Gross, see 93 F.3d at 996, Judge Cohen properly dismissed the claim for fraud that is based upon alleged failure to comply with generally accepted accounting principles. The plaintiffs contend that they have provided far more detail here than the plaintiffs did in Gross, and in part that is true. What is missing, however, is adequate quantification. The class period for which this lawsuit is brought does not begin until the *third* quarter of 1996. The only numbers the plaintiffs provide on the materiality of any failure to comply with generally accepted accounting principles are with respect to sales of a canine allergy test. They assert that although the test was not yet ready for distribution because it had not been through final evaluative testing, the company sold $2 million of these tests in the fourth quarter of 1995 and up to $1.5 million in the first quarter of 1996, then proceeded to accept returns of the product in exchange for a different product during the second quarter of 1996 and into the third quarter of 1996. The plaintiffs assert without explaining their arithmetic that the canine allergy test sales resulted in a five percent increase of

pretax income for the first half of 1996 (before the class period), see Amended Compl. at ¶ 72, and that second-quarter and first-half income were published to the market in July of 1996 (during the class period) in a press release and in the SEC 10-Q filing for the second quarter of 1996, see id. at ¶¶ 44-45. The Amended Complaint reveals that gross revenues for all of 1996 were $267,677,000 and net income was $32,640,00. (The respective numbers for 1995 were $188,602,000 and $21,494,000.) See id. at ¶ 52. It further reveals that net income for the first half of 1996 was $14,853,000, but it does not reveal the gross revenues reported for that six month period. See id. at ¶ 44. There is no further elaboration of how any improper recognition of revenue from canine allergy test sales in the first quarter of 1996 was material, nor do the plaintiffs provide any quantification of the exchanges that allegedly followed in the second quarter of 1996 or show how the net result was a 5% overstatement of pretax income for the first half of 1996. Although the plaintiffs have tried to go into greater detail than the plaintiffs did in Gross, I agree with the Magistrate Judge that ultimately they have failed to provide the numbers that Gross requires to sustain the claim of fraud based on failure to comply with generally accepted accounting principles.

4. I reject the basis upon which the Magistrate Judge dismissed the claims against the individual defendants with respect to paragraphs 51, 53 and 54 of the Amended Complaint; the plaintiffs' theory was based upon not simply the group publication doctrine, but also Section 20(a) of the Exchange Act, see 15 U.S.C.§ 78t(a), the control person test, because of the individual defendants' status. Contrary to the defendants' position, I conclude that the law does not require the plaintiffs to allege culpability on the part of the individual defendants who were control persons, but only an underlying violation of the securities laws and their status as control persons. See Rand v. M/A-Com,

Inc., 824 F. Supp. 242, 262 (D. Mass. 1992). The First Circuit has not spoken on this topic,[5] but that conclusion seems clear from the plain language of the statute.

> Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

15 U.S.C. § 78t(a). If the plaintiffs must allege and prove culpability, then the control person provision adds little to the securities laws. Instead, it is clear from the language of the statute that good faith is an affirmative defense and therefore that the issue of culpability is part of the control person's case.

5. The allegations of paragraphs 51, 53, and 54, however, must be dismissed for lack of specificity and source. The law in the First Circuit is clear. Romani v. Shearson Lehman Hutton, 929 F.2d 875, 878 (1st Cir. 1991), requires that where allegations are based upon information and belief, the source of the information must be provided. The assertions in paragraphs 51, 53 and 54 concerning what IDEXX allegedly told analysts are necessarily based on information and belief, but no sources are revealed. The opening paragraph of the Amended Complaint alleges general categories of sources. The apparently relevant ones for these paragraphs are media reports, former IDEXX employees or IDEXX competitors. That attribution simply is too vague to meet the Romani standard. The obvious purpose of the Romani standard is to insure that defendants are not wrongfully subjected

[5] Other Circuits are divided on this topic. See Rand, 824 F. Supp. at 262. The Second Circuit appears to be internally split at the district court level on this question. See Food & Allied Serv. Trades Dep't, AFL-CIO v. Millfield Trading Co., 841 F. Supp. 1386, 1390 (S.D.N.Y. 1994).

to a lawsuit when the statements in question may not even be attributable to them. Here, the risk is that any objectionable statements in these paragraphs were created by the analysts rather than made by the defendants; without any assertion of the source, that risk is too great. Moreover, in addition to not disclosing their source, the plaintiffs have not specified who made the alleged actionable statements. The Magistrate Judge concluded that because the plaintiffs are seeking to hold IDEXX as a corporation liable, an assertion that senior management made the statements is sufficient. I disagree. First Circuit cases are clear that the plaintiffs must identify specifically who made the statements, see Suna v. Bailey Corp., 107 F.3d 64, 68 (1st Cir. 1997), and the policy reasons for that requirement are the same whether a defendant is a corporation or an individual.[6]

The one exception to the failure to specify who made a statement and to give a source is the penultimate statement of paragraph 51: "Reuters reported that defendant Shaw thought that a $0.02 per share earnings estimate reduction [for the fourth quarter of 1996] was 'conservative'." But there is no sufficient basis in the Amended Complaint to support the assertion that the statement is false.

Giving the plaintiffs the benefit of every inference, the Amended Complaint alleges that the market reasonably interpreted Shaw's statement to mean that analysts had been overcautious in reducing fourth-quarter earnings estimates by two cents, that IDEXX's actual earnings would be slightly better and that Shaw knew this prediction to be false. The Amended Complaint then states the results of the fourth quarter of 1996 reflecting substantial increases from the previous years. See

[6] Judge Young of the District of Massachusetts has gone so far as to say that an identification of two speakers with the conjunction "and/or" is insufficient. See Lirette v. Shiva Corp., 27 F. Supp.2d 268, 276 n.7, 280 (D. Mass. 1998). I need not go that far in this case. See also Kriendler, 877 F. Supp. at 1155 ("An entity speaks through its agents. Allegations that fail to identify the agents who speak for the entity do not satisfy Rule 9(b)."); Wallace v. Systems & Computer Tech. Corp., 1996 Fed. Sec. L. Rep. ¶ 99,212, 1996 WL 195382 at *7 (E.D. Pa.) (holding that reference to "management" or "top officers and key members of [corporation's] management team" are not enough to satisfy Rule 9(b)).

Amended Compl. at ¶ 52. It does not state what the analysts' projections had been or how these results compared to the "conservative" two cents per share reduction. Thus, on the numbers alone there is no basis to conclude that the alleged statement by Shaw to Reuters was materially false. But giving the plaintiffs the benefit of every inference once again,[7] I assume that what the plaintiffs mean is that even if the reported results did match up with the projections, the Shaw-Reuters statement was materially misleading because Shaw knew that any such reported results would fail to comply with generally accepted accounting principles, as alleged elsewhere in the Amended Complaint. Nevertheless, the Amended Complaint is still deficient because the plaintiffs have not quantified the impact, if any, of the supposed noncompliance with generally accepted accounting principles on reported or projected results, and materiality, therefore, cannot be gauged. In sum, all the Amended Complaint provides is the bald assertion that Shaw's statement as reported in Reuters was false, but without any factual basis to support the alleged falsity.

There is therefore no underlying securities law violation and the Amended Complaint must be **DISMISSED** as to the individual defendants (whose only remaining liability is based on Section 20(a)), as well as the company.

6. I decline to rule at this time that the plaintiffs should not be allowed to amend their complaint under Rule 15. I have no desire to see the matter drag on, however. Either the plaintiffs have what they need or they do not. Therefore any motion to amend must be filed by April 21, 1999. In any such motion for leave to file, I want specificity as to exactly what is to be added or changed,

[7] There is actually no specific allegation that the reported results for the fourth quarter of 1996 deviated from generally accepted accounting principles in any way; the specific allegations on this topic pertain to the financial statements and operating results for the second and third quarters of 1996. See Amended Compl. at ¶¶ 65, 66. I will assume that the Amended Complaint should be read more broadly.

not simply a restated complaint, so that argument can be focused upon whether the changes/additions are adequate to survive a 12(b)(6) motion, and whether justice requires allowing the amendment. See Fed. R. Civ. P. 15(a).

SO ORDERED.

DATED THIS 31ST DAY OF MARCH, 1999.

D. BROCK HORNBY
UNITED STATES CHIEF DISTRICT JUDGE